

STATE OF MICHIGAN
DEPARTMENT OF ENERGY, LABOR AND ECONOMIC GROWTH
OFFICE OF FINANCIAL AND INSURANCE REGULATION

BEFORE THE COMMISSIONER OF THE OFFICE OF FINANCIAL AND INSURANCE REGULATION

In the matter of

MORGAN STANLEY & CO.
INCORPORATED (CRD #8209)

Respondent.

ADMINISTRATIVE CONSENT ORDER

WHEREAS, Morgan Stanley & Co. Incorporated ("Morgan Stanley") is a broker-dealer registered in the state of Michigan; and

WHEREAS, coordinated investigations of the activities of Morgan Stanley in connection with the marketing and sale of auction rate securities ("ARS") have been conducted by a multistate task force composed of members of the North American Securities Administrators Association Inc. ("NASAA"); and

WHEREAS, Morgan Stanley has cooperated with regulators conducting the investigations by responding to inquiries, providing documentary evidence and other materials, and providing regulators with access to facts relating to the investigations; and

WHEREAS, Morgan Stanley has advised regulators of its agreement to resolve the investigations relating to its marketing and sale of ARS to retail investors; and

WHEREAS, Morgan Stanley agrees to, among other things, reimburse certain purchasers of ARS, implement certain changes with respect to its marketing and sale of ARS, and make certain payments; and

WHEREAS, Morgan Stanley elects to permanently waive any right to a hearing and appeal under the Administrative Procedures Act of 1969, 1969 PA 306, as amended, MCL 24.201 *et seq.* and the Michigan Uniform Securities Act of 1964, 1964 PA 265, as amended, MCL 451.501 *et*

1 *seq.*, and the Rules promulgated thereunder R 451.601.1 – 451.808.8, (the Uniform Securities Act),
2 with respect to this Administrative Consent Order (the “Order”);

3 WHEREAS, Morgan Stanley admits the jurisdiction of the Michigan Office of Financial
4 and Insurance Regulation (“OFIR”); acknowledges, without admitting or denying the truth thereof,
5 that the following allegations contained in the Notice of Hearing shall be adopted as OFIR’s
6 Findings of Fact; and consents to the entry of this Order by OFIR:

7 NOW, THEREFORE, the Commissioner of OFIR, as administrator of the Uniform
8 Securities Act, hereby enters this order:

9 I.

10 **FINDINGS OF FACT**

11 **Unethical Practices in the Offer and Sale of ARS**

12 1. ARS are financial instruments that include auction preferred shares of closed-end
13 funds, municipal auction rate bonds, and various asset-backed auction rate bonds (collectively
14 referred to herein as "ARS"). ARS are long-term instruments where the interest/dividend is reset
15 weekly or monthly.

16 2. Morgan Stanley participated in the marketing and sale of ARS.

17 3. In certain instances, Morgan Stanley, through its salespeople, advised certain clients
18 that ARS were safe, liquid investments, when in fact ARS had significant liquidity risks associated
19 with them.

20 4. Representatives of Morgan Stanley represented to certain customers of Morgan
21 Stanley that ARS were short-term investments. In fact, because ARS are bonds with long-term
22 maturities, their short-term liquidity was dependent on the successful operation of a bidding
23 process known as a Dutch auction. Certain representatives of Morgan Stanley failed to disclose to
24 certain customers with short-term liquidity needs that they might be unable to sell their ARS if the
25 auction process failed.

1 5. In connection with the sale of ARS, certain Morgan Stanley salespeople told certain
2 investors that ARS were “just like cash” and “liquid with seven days notice.”

3 6. Morgan Stanley marketed ARS to investors within a brochure entitled "Money
4 Market Instruments." Within this brochure, ARS are listed under the subsection "Other Short-
5 Term Instruments."

6 7. Since it began participating in the ARS market, Morgan Stanley submitted support
7 bids—purchase orders for the entirety of an auction rate security issue for which it acted as the sole
8 or lead broker. Support bids were Morgan Stanley proprietary orders that would be filled, in whole
9 or in part, if there was otherwise insufficient demand in an auction. When Morgan Stanley
10 purchased ARS through support bids, ARS were then owned by Morgan Stanley and the holdings
11 were recorded on Morgan Stanley's balance sheet. For risk management purposes, Morgan Stanley
12 imposed limits on the amounts of ARS it could hold in inventory.

13 8. Because many investors could not ascertain how much of an auction was filled
14 through Morgan Stanley proprietary trades, they could not determine if auctions at Morgan Stanley
15 were clearing because of normal marketplace demand, or because Morgan Stanley was making up
16 for the lack of demand through support bids. Generally, investors were also not aware that the
17 liquidity of the ARS as to which Morgan Stanley was the managing broker-dealer depended upon
18 Morgan Stanley's continued use of support bids. While Morgan Stanley could track its own
19 inventory as a measure of the supply and demand for its ARS, ordinary investors had no
20 comparable ability to assess the operation of Morgan Stanley's auctions. There was no way for
21 such investors to monitor supply and demand in the market or to assess when broker-dealers might
22 decide to stop supporting the market, thereby causing its collapse.

23 9. Starting in August 2007, the credit crisis and other deteriorating market conditions
24 strained the ARS market. Some institutional investors withdrew from the market, decreasing
25 demand for ARS.

1 10. The resulting market dislocation should have been evident to Morgan Stanley.
2 Morgan Stanley's support bids filled the increasing gap in the demand in its auctions for ARS,
3 sustaining the impression that the demand for ARS had not decreased. As a result, Morgan
4 Stanley's ARS inventory grew significantly, requiring Morgan Stanley to raise its risk management
5 limits on its ARS inventory.

6 11. From Fall 2007 through February 2008, demand for ARS continued to erode and
7 Morgan Stanley's ARS inventory reached unprecedented levels. Morgan Stanley eventually
8 became aware of the increasing strains in the ARS market, and recognized the potential for
9 widespread market failure. Morgan Stanley never disclosed these increasing risks of owning or
10 purchasing ARS to its customers.

11 12. In February 2008, Morgan Stanley and other firms stopped supporting the auctions.
12 Without the benefit of support bids, the ARS market collapsed, leaving investors who had been led
13 to believe that these securities were cash alternative investments appropriate for managing short-
14 term cash needs, holding long-term or perpetual securities that could not be sold at par value until
15 and if the auctions cleared again.

16 **Failure to Supervise**

17 13. Although ARS are complex products, Morgan Stanley did not provide its sales or
18 marketing staff with the training necessary to adequately explain these products or the mechanics
19 of the auction process to their customers.

20 14. Morgan Stanley did not adequately train all of its brokers and financial advisers
21 regarding the potential illiquidity of ARS, including the fact that Morgan Stanley may stop
22 supporting the market.

23 **II.**

24 **CONCLUSIONS OF LAW**

25 15. OFIR has jurisdiction over this matter pursuant to the Uniform Securities Act.
26

1 16. OFIR finds that the above conduct subjects Morgan Stanley to sanctions under
2 Section 204(a)(1)(g) of the Uniform Securities Act, MCL 451.604(a)(1)(g), for dishonest and
3 unethical business practices and Section 204(a)(2) of the Uniform Securities Act, MCL
4 451.604(a)(2) for failure to supervise its agents.

5 17. OFIR finds the following relief appropriate and in the public interest.

6 **III.**

7 **ORDER**

8 On the basis of the Findings of Fact, Conclusions of Law, and Morgan Stanley's consent to
9 the entry of this Order, for the sole purpose of settling this matter prior to a hearing and without
10 admitting or denying the Findings of Fact or Conclusions of Law,

11 **IT IS HEREBY ORDERED:**

12 1. This Order concludes the investigation by OFIR and any other action that OFIR
13 could commence under applicable law on behalf of the state of Michigan as it relates to Morgan
14 Stanley's marketing and sale of ARS to Morgan Stanley's Retail ARS Investors, as defined below.
15 Specifically excluded from and not covered by this paragraph are any claims by OFIR arising from
16 or relating to the Order provisions contained herein.

17 2. This Order is entered into solely for the purpose of resolving the investigation into
18 Morgan Stanley's marketing and sale of ARS, and is not intended to be used for any other purpose.

19 3. This Order shall be binding upon Respondent Morgan Stanley and its successors
20 and assigns as well as to successors and assigns of relevant affiliates with respect to all conduct
21 subject to the provisions above and all future obligations, responsibilities, undertakings,
22 commitments, limitations, restrictions, events, and conditions.

23 4. Morgan Stanley shall cease and desist from violating the Uniform Securities Act
24 and will hereafter comply with the Uniform Securities Act.

25 5. Morgan Stanley shall pay the aggregate sum of \$35 million dollars to participating
26 jurisdictions.

1 6. Within ten (10) calendar days following the entry of this Order, Morgan Stanley
2 shall pay to the State of Michigan the sum of \$408,342.47, allocated in the following manner:
3 \$367,508.22 to the State of Michigan General Fund, and \$40,834.25 to the Michigan Investor
4 Protection Trust.

5 7. In the event another state securities regulator determines not to accept Morgan
6 Stanley's settlement offer, the total amount of the payment to the state of Michigan shall not be
7 affected.

8 **Requirement to Repurchase ARS from Retail ARS Investors**

9 8. Morgan Stanley shall provide liquidity to Retail ARS Investors by buying-back, at
10 par, in the manner described below, Eligible ARS that were not clearing as of September 30, 2008.

11 9. "Eligible ARS," for the purposes of this Order, shall mean ARS purchased at
12 Morgan Stanley prior to February 13, 2008.

13 10. "Retail ARS Investors," for the purposes of this Order, shall mean:

14 i. Natural persons (including their IRA accounts, testamentary trust and estate
15 accounts, custodian UGMA and UTMA accounts, and guardianship accounts) who
16 purchased Eligible ARS at Morgan Stanley;

17 ii. Charities and nonprofits with Internal Revenue Code Section 501(c)(3)
18 status that purchased Eligible ARS at Morgan Stanley; and

19 iii. Small Businesses that purchased Eligible ARS at Morgan Stanley. For
20 purposes of this provision, "Small Businesses" shall mean Morgan Stanley customers not
21 otherwise covered in paragraph 10(i) and (ii) above that had \$10 million or less in assets in
22 their accounts with Morgan Stanley, net of margin loans, as determined by the customer's
23 aggregate household position(s) at Morgan Stanley as of August 31, 2008, or, if the
24 customer was not a customer of Morgan Stanley as of August 31, 2008, as of the date that
25 the customer terminated its customer relationship with Morgan Stanley. Notwithstanding
26

1 any other provision, "Small Businesses" does not include broker-dealers or banks acting as
2 conduits for their customers.

3 11. Morgan Stanley shall offer to purchase, at par plus accrued and unpaid
4 dividends/interest, from Retail ARS Investors their Eligible ARS that were not clearing as of
5 September 30, 2008 ("Buyback Offer"), and explain to such Retail ARS Investors what they must
6 do to accept, in whole or in part, the Buyback Offer. The Buyback Offer shall remain open until at
7 least January 11, 2009 ("Offer Period"). Morgan Stanley may in its sole discretion extend the
8 Offer Period beyond this date.

9 12. Morgan Stanley shall have undertaken its best efforts to identify and provide notice
10 to Retail ARS Investors who invested in Eligible ARS that were not clearing as of September 30,
11 2008, of the relevant terms of this Order by October 20, 2008.

12 13. Retail ARS Investors may accept the Buyback Offer by notifying Morgan Stanley at
13 any time before midnight, Eastern Time, January 11, 2009, or such later date and time as Morgan
14 Stanley may in its sole discretion decide to extend the Offer Period. For Retail ARS Investors who
15 accept the Buyback Offer prior to December 11, 2008, Morgan Stanley shall have purchased their
16 Eligible ARS by December 15, 2008. Morgan Stanley shall have purchased the Eligible ARS of all
17 other Retail ARS Investors who accept the Buyback Offer within the Offer Period, on or before
18 January 16, 2009.

19 14. If at any time between January 12, 2009, and December 31, 2009, a Retail ARS
20 Investor who did not accept the Buyback Offer contacts Morgan Stanley and affirms that he or she
21 did not receive notice of the Buyback Offer prior to January 11, 2009, Morgan Stanley will
22 purchase the Eligible ARS of such investor.

23 15. No later than October 20, 2008, Morgan Stanley shall have established: a) a
24 dedicated toll-free telephone assistance line, with appropriate staffing, to provide information and
25 to respond to questions concerning the terms of this Order; and b) a public Internet page on its
26 corporate Web site(s), with a prominent link to that page appearing on Morgan Stanley's relevant

1 homepage(s), to provide information concerning the terms of this Order and, via reasonable means,
2 to respond to questions concerning the terms of this Order. Morgan Stanley shall maintain the
3 telephone assistance line and Internet page through December 31, 2009.

4 **Review of Customer Accounts**

5 16. For a period of two years from the date of this Order, upon request from any firm
6 that is repurchasing ARS, Morgan Stanley shall take reasonable steps to provide notice of that
7 firm's offer to repurchase ARS to Morgan Stanley customers that Morgan Stanley can reasonably
8 identify, that hold such ARS subject to the other firm's repurchase.

9 **Relief for Investors Who Sold Below Par**

10 17. No later than December 11, 2008, Morgan Stanley shall pay any Retail ARS
11 Investor that Morgan Stanley can reasonably identify who sold Eligible ARS below par between
12 February 13, 2008, and August 13, 2008, the difference between par and the price at which the
13 Retail ARS investor sold the Eligible ARS.

14 **Claims for Consequential Damages**

15 18. Notwithstanding this Order, an investor may pursue any claims related to the sale of
16 ARS via any method normally available to the investor. However, if the investor is pursuing claims
17 related exclusively to consequential damages, Morgan Stanley shall provide the investor with the
18 option to proceed in arbitration according to the following provisions:

19 a. The arbitrations will be conducted by a single public arbitrator in accordance
20 with FINRA's special arbitration procedures for claims of consequential damages filed by
21 Retail ARS Investors;

22 b. Morgan Stanley shall pay all applicable FINRA forum and FINRA filing
23 fees;

24 c. Any Morgan Stanley Retail ARS Investors who choose to pursue such
25 claims shall bear the burden of proving that they suffered consequential damages and that
26

1 such damages were caused by the investors' inability to access funds consisting of Eligible
2 ARS holdings purchased at Morgan Stanley; and

3 d. Morgan Stanley shall be able to defend itself against such claims; provided,
4 however, that Morgan Stanley shall not contest liability related to the sale of ARS, and
5 provided further that Morgan Stanley shall not be able to use as part of its defense a
6 Morgan Stanley Retail ARS Investor's decision not to borrow money from Morgan Stanley.

7 19. Retail ARS Investors who elect to use the special arbitration process provided for
8 herein shall not be eligible for punitive damages.

9 20. All customers, including but not limited to Retail ARS Investors who avail
10 themselves of the relief provided pursuant to this Order, may pursue any remedies against Morgan
11 Stanley available under the law. However, Eligible Investors that elect to utilize the special
12 arbitration process set forth above are limited to the remedies available in that process and may not
13 bring or pursue a claim against Morgan Stanley or in any case where Morgan Stanley is
14 underwriter relating to Eligible ARS in another forum.

15 **Institutional Investors**

16 21. Morgan Stanley shall endeavor to work with issuers and other interested parties,
17 including regulatory and governmental entities, to expeditiously provide liquidity solutions for
18 institutional investors that purchased ARS not covered by the Retail ARS Investor repurchase
19 provisions delineated above.

20 22. Beginning December 11, 2008, and within forty-five (45) days of the end of each
21 quarter thereafter, Morgan Stanley shall submit a written report to a representative specified by
22 NASAA outlining the efforts in which Morgan Stanley has engaged and the results of those efforts
23 with respect to Morgan Stanley institutional investors' holdings in Eligible ARS. Morgan Stanley
24 shall, at the option of the representative specified by NASAA, confer with such representative no
25 less frequently than quarterly to discuss Morgan Stanley's progress. Such quarterly meetings shall
26 continue until no later than December 2009. Following every quarterly meeting, the representative

1 shall advise Morgan Stanley of any concerns and, in response, Morgan Stanley shall detail the
2 steps that Morgan Stanley plans to implement to address such concerns. The reporting or meeting
3 deadlines set forth above may be amended upon Morgan Stanley's request if written permission is
4 received from the representative specified by NASAA.

5 **Relief for Municipal Issuers**

6 23. Morgan Stanley shall promptly refund to municipal issuers refinancing fees the
7 issuers paid to Morgan Stanley for the refinancing of their ARS, where such refinancing occurred
8 between February 11, 2008, and the date of this Order and where Morgan Stanley acted as
9 underwriter for the primary offering of the ARS between August 1, 2007, and February 11, 2008.
10 Nothing in this Order precludes OFIR from pursuing any other civil action that may arise with
11 regard to ARS other than the marketing and sale of ARS to retail investors.

12 **Additional Considerations**

13 24. Nothing herein shall preclude the State of Michigan, its departments, agencies,
14 boards, commissions, authorities, political subdivisions and corporations (collectively, "State
15 Entities"), other than OFIR and only to the extent set forth in paragraph 1 above, and the officers,
16 agents or employees of State Entities from asserting any claims, causes of action, or applications
17 for compensatory, nominal and/or punitive damages, administrative, civil, criminal, or injunctive
18 relief against Morgan Stanley in connection with certain ARS practices at Morgan Stanley.

19 25. This Order shall not disqualify Morgan Stanley or any of its affiliates or current or
20 former employees from any business that they otherwise are qualified or licensed to perform under
21 applicable state law and this Order is not intended to form the basis for any disqualification.

22 26. To the extent applicable, this Order hereby waives any disqualification from relying
23 upon the registration exemptions or registration safe harbor provisions that may be contained in the
24 federal securities laws, the rules and regulations thereunder, the rules and regulations of self
25 regulatory organizations or any states' or U.S. Territories' securities laws. In addition, this Order is
26 not intended to form the basis for any such disqualifications. In addition, this Order is not intended

1 to form the basis of a statutory disqualification under Section 3(a)(39) of the Securities Exchange
2 Act of 1934.

3 27. This Order and any dispute related thereto shall be construed and enforced in
4 accordance with, and governed by, the laws of the state of Michigan without regard to any choice
5 of law principles.

6 28. Evidence of a violation of this Order proven in a court of competent jurisdiction
7 shall constitute prima facie proof of a violation of the Uniform Securities Act, in any action or
8 proceeding hereafter commenced by OFIR against Morgan Stanley.

9 29. Should OFIR prove in a court of competent jurisdiction that a material breach of this
10 Order by Morgan Stanley has occurred, Morgan Stanley shall pay to OFIR the cost, if any, of such
11 determination and of enforcing this Order including without limitation legal fees, expenses, and
12 court costs.

13 30. If Morgan Stanley fails to make the payment specified in paragraph 6, OFIR may, at
14 its sole discretion, pursue any legal remedies, including but not limited to initiating an action to
15 enforce the Order, revoking Morgan Stanley's registration within the state, or terminating this
16 Order.

17 31. If in any proceeding, after notice and opportunity for a hearing, a court of competent
18 jurisdiction, including an administrative proceeding by a state securities administrator, finds that
19 there was a material breach of this Order, OFIR, at its sole discretion, may terminate the Order. If
20 Morgan Stanley defaults on any other obligation under this Order, OFIR may, at its sole discretion,
21 pursue legal remedies to enforce the Order or pursue an administrative action, including but not
22 limited an action to revoke Morgan Stanley's registration within the state. Morgan Stanley agrees
23 that any statute of limitations or other time related defenses applicable to the subject of the Order
24 and any claims arising from or relating thereto are tolled from and after the date of this Order. In
25 the event of such termination, Morgan Stanley expressly agrees and acknowledges that this Order
26 shall in no way bar or otherwise preclude OFIR from commencing, conducting or prosecuting any

1 investigation, action, or proceeding, however denominated, related to the Order, against Morgan
2 Stanley, or from using in any way any statements, documents or other materials produced or
3 provided by Morgan Stanley prior to or after the date of this Order, including, without limitation,
4 such statements, documents or other materials, if any, provided for purposes of settlement
5 negotiations, except as may otherwise be provided in a written agreement with OFIR.

6 32. Morgan Stanley shall cooperate fully and promptly with OFIR and shall use its best
7 efforts to ensure that all the current and former officers, directors, trustees, agents, members,
8 partners, and employees of Morgan Stanley (and of any of Morgan Stanley's parent companies,
9 subsidiaries, or affiliates) cooperate fully and promptly with OFIR in any pending or subsequently
10 initiated investigation, litigation, or other proceeding relating to ARS and/or the subject matter of
11 the Order. Such cooperation shall include, without limitation, and on a best efforts basis:

12 a. production, voluntarily and without service of subpoena, upon the request of
13 OFIR, of all documents or other tangible evidence requested by OFIR and any compilations
14 or summaries of information or data that OFIR requests that Morgan Stanley (or the
15 Morgan Stanley's parent companies, subsidiaries, or affiliates) prepare, except to the extent
16 such production would require the disclosure of information protected by the attorney-client
17 and/or work product privileges;

18 b. without the necessity of a subpoena, having the current (and making all
19 reasonable efforts to cause the former) officers, directors, trustees, agents, members,
20 partners, and employees of Morgan Stanley (and of any of the Morgan Stanley's parent
21 companies, subsidiaries, or affiliates) attend any Proceedings (as hereinafter defined) in the
22 state of Michigan or elsewhere at which the presence of any such persons is requested by
23 OFIR and having such current (and making all reasonable efforts to cause the former)
24 officers, directors, trustees, agents, members, partners, and employees answer any and all
25 inquiries that may be put by OFIR to any of them at any proceedings or otherwise, except to
26 the extent such production would require the disclosure of information protected by the

1 attorney-client and/or work product privileges. "Proceedings" include, but are not limited
2 to, any meetings, interviews, depositions, hearings, trials, grand jury proceedings, or other
3 proceedings;

4 c. fully, fairly, and truthfully disclosing all information and producing all
5 records and other evidence in its possession, custody, or control (or the possession, custody,
6 or control of the Morgan Stanley parent companies, subsidiaries, or affiliates) relevant to all
7 inquiries made by OFIR concerning the subject matter of the Order, except to the extent
8 such inquiries call for the disclosure of information protected by the attorney-client and/or
9 work product privileges; and

10 d. making outside counsel reasonably available to provide comprehensive
11 presentations concerning any internal investigation relating to all matters in the Order and
12 to answer questions, except to the extent such presentations or questions call for the
13 disclosure of information protected by the attorney-client and/or work product privileges.

14 33. In the event Morgan Stanley fails to comply with paragraph 32 of the Order, the
15 OFIR shall be entitled to specific performance, in addition to any other available remedies.

16 Dated this 23rd day of November, 2009.

17
18 BY ORDER OF THE COMMISSIONER OF THE OFFICE
19 OF FINANCIAL AND INSURANCE REGULATION

20 

21 Ken Ross, Commissioner
22 Office of Financial and Insurance Regulation
23
24
25
26

1 **CONSENT TO ENTRY OF ADMINISTRATIVE ORDER BY MORGAN STANLEY & CO.**
2 **INCORPORATED**

3 Morgan Stanley & Co. Incorporated ("Morgan Stanley") hereby acknowledges that it has
4 been served with a copy of this Administrative Order, has read the foregoing Order, is aware of its
5 right to a hearing and appeal in this matter, and has waived the same.

6 Morgan Stanley admits the jurisdiction of OFIR, neither admits nor denies the Findings of
7 Fact and Conclusions of Law contained in this Order; and consents to entry of this Order by OFIR as
8 settlement of the issues contained in this Order.

9 Morgan Stanley agrees that it shall not claim, assert, or apply for a tax deduction or tax
10 credit with regard to any state, federal or local tax for any administrative monetary settlement that
11 Morgan Stanley shall pay pursuant to this Order.

12 Morgan Stanley states that no promise of any kind or nature whatsoever was made to it to
13 induce it to enter into this Order and that it has entered into this Order voluntarily.

14 S. Anthony Taggart represents that he/she is Executive Director of Morgan
15 Stanley and that, as such, has been authorized by Morgan Stanley to enter into this Order for and on
16 behalf of Morgan Stanley.

17 Dated this 10th day of December, 2009.

18 MORGAN STANLEY & CO. INCORPORATED

19 By: [Signature]

20 Title: Executive Director

21 STATE OF New York)

22 County of New York)

23 SUBSCRIBED AND SWORN TO before me this 10th day of December, 2009

24 [Signature]
25 Notary Public

26 My commission expires:

7/9/11

YOKO NITTA
Notary Public, State Of New York
No. 01N16060999 - Queens
Qualified In New York County
Commission Expires July 9, 20 11